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Explanations and Qualifications in Accountants' Certificates

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Institute of Accountants, Washington, D. C.—October, 1955*

The most difficult problem in drafting accountants' certificates* concerns explanations and qualifications. A clearer understanding of our objectives in this respect will be helpful to us.

Possibly the best springboard for our consideration lies in those sections of our generally accepted auditing standards dealing with Standards of Field Work and Standards of Reporting; therefore I suggest we start with a review of these sections:

"Standards of Field Work:

1. The work is to be adequately planned and assistants, if any, are to properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

*For convenience I have selected the expression "accountants' certificates" from the group including that expression as well as "accountants' reports", "accountants' opinions", etc.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking."*

Now let us see how these standards are embodied in a typical certificate (Codification of Statements on Auditing Procedure, page 16):

"We have examined the balance sheet of X Company as of December 31, 195_ and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances (this is the "scope" paragraph).

"In our opinion, the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." (This is the "opinion" paragraph.)

You will note that this certificate includes two general representations, with two subdivisions of one of them, which may be subject to qualification, as follows:

1. That the scope of our examination was adequate to enable us to form our opinion as to the statements and the accounting principles reflected therein.

2. That we have formed the opinion that the statements present fairly the financial position and results of operations - since they possess the essentials of being:

(a) In accordance with generally accepted accounting principles - which means essentially that each of the respective items is as fairly stated as can practicably be determined under the principles being followed, and

(b) based upon consistent application of the same principles as

*"Generally Accepted Auditing Standards - Their Significance and Scope," American Institute of Accountants, Committee on Auditing Procedure, 1954, pp. 13-14.

(usually) in the statements for the period immediately preceding.

Simply stated, therefore, if we feel we must take any important exceptions or reservations to the truth of any of these representations, they must be dealt with in our report. If our exceptions or reservations are not so material as to negative an opinion on the financial statements taken as a whole, we should issue a qualified certificate; however, if the exceptions or reservations are so material as to negative an opinion we must generally disclaim an opinion.

It is possibly appropriate to consider here a few general observations as to the issuance of qualified certificates:

1. We should aim so to present our qualifications or explanations that their significance and application will be clearly understood.

2. Qualifications or explanations should be placed as close as practicable to the assertions which they are intended to qualify or explain.

3. Our objective should be to have our certificate as complete and self-contained as practicable.

4. We should strive for clarity in expression.

5. We must avoid ambiguous expressions and statements - items such as "subject to the foregoing" or "subject to the footnotes to the financial statements" may leave the reader in doubt as to what our opinion is.

Now let's try to apply these observations to some hypothetical cases. First, let's consider some cases dealing with reservations as to the scope of our work. Assume you are engaged after a balance sheet date to make an examination for the preceding fiscal year of a client, you were not present at the physical inventory taking, have not otherwise been able to satisfy yourself as to physical quantities by testing or observation, and that the inventories are a material item.

The omission of the generally accepted procedure of inventory testing or observation requires qualification of the scope paragraph. This can be done by adding to the scope paragraph something like "except that our examination of the inventories did not include physical tests of quantities". If desired this can be amplified to cover affirmatively what was done, by saying something like "except that our examination of the inventories was limited to review of the related records and procedures and tests of the prices and computations, and did not include physical tests of quantities". Ordinarily the reason why the

scope of your work was limited should also be stated.

Any qualification of the scope of your work requires either (1) a qualified opinion or (2) the denial of an opinion. Where the qualification as to scope is material then usually you should deny an opinion.

In our instant hypothetical case a denial seems to be required. This might be stated (in the opinion paragraph) somewhat as follows: "By reason of the limitation of the scope of our examination as to inventories (see preceding paragraph) we are not in a position to express an opinion as to the over-all fairness of the accompanying balance sheet as of December 31, 19__ or of the related statement(s) of income and surplus for the year then ended. In all other respects, however, it is our opinion that these statements have been prepared in accordance with generally accepted accounting principles applied on a consistent basis (or applied on a basis consistent with the prior year)." (It may be noted here that some practitioners would omit the preceding sentence (on the grounds that it is tantamount to giving an "opinion" when, in fact, an opinion - at least an over-all one - is being denied) and, in lieu thereof, comment specifically on each material item in the statements; I think either treatment is acceptable but am inclined to prefer the first one mainly because I believe it more clearly conveys your conclusions to the reader.)

Fortunately, the profession has not attempted to tie our hands with stereotyped phrases for expressing our qualifications. Accordingly, you may well be able to improve on the illustrative wording used in the preceding hypothetical case. At all times, however, remember to strive for clarity and to avoid ambiguity.

Another area where the scope of your work may be qualified concerns confirmation of receivables, so let's take a second hypothetical case involving this. We will again assume that receivables are material in amount. If you are not able to employ satisfactory alternative procedures your treatment of the problem will probably parallel that suggested heretofore as to our hypothetical inventory problem.

Frequently, however, you can employ satisfactory alternative procedures so let's see how our problem might be handled then. Of course, the omission of the generally accepted procedure of confirming receivables requires mention in the scope paragraph. However (and this is important), if you have been able to employ satisfactory alternative procedures the reference becomes an explanation rather than a qualification. Accordingly, I suggest that a semicolon be placed at the

end of the standard scope paragraph and something like the following be added: "it was not practicable to confirm receivables but we have satisfied ourselves with respect thereto by means of other auditing procedures". Again, remember that the wording is suggestive, the profession not attempting to prescribe wording.

Since the receivable matter now has the status of an explanation, and not a qualification, no reference is required in the opinion paragraph.

I should like to stress here the necessity of distinguishing between explanations and qualifications. This distinction must be met squarely by the practitioner - he must not leave the reader in doubt in which category the particular item falls.

Let's consider next a qualification arising from failure of the statements to conform to generally accepted accounting principles - for example, the omission of overhead costs from inventory. Assume an understatement of inventories of \$100,000 at the beginning of the year and \$200,000 at the end of the year, and a 52% Federal income tax rate; also assume the items are material.

Mechanically, it will probably be easier to treat with this qualification in an intermediate paragraph of the certificate, as for example:

"The Company has consistently valued its inventories of in process and finished goods at the cost of direct labor and materials, no consideration being given to overhead costs; this is not in accordance with generally accepted accounting principles which require the inclusion of such costs. Had such costs been included the inventories at December 31, 19__ would have been \$200,000 greater, retained earnings at that date \$96,000 greater, and net income for the year then ended \$48,000 greater, than reported."

The opinion paragraph might be expressed somewhat as follows:

"Except as the financial statements are affected by the omission of overhead costs in inventories, as commented on in the preceding paragraph, the accompanying balance sheet - - - - ." I realize that in this situation some practitioners would disclaim an opinion (because of materiality). I do not think this area has yet been sufficiently explored in our literature. At what point do your qualifications become so material that you should disclaim an opinion? Personally it seems to me that it is illogical to disclaim an opinion if you, in fact, have one even though it may be an "adverse" opinion. If the effect of the qualification can be clearly stated I do not think a disclaimer is necessary.

This leaves for consideration a change from one accepted account-

ing practice to another accepted accounting practice which requires only a qualification as to consistency. The effect of the change on the financial statements should be clearly stated. Preferably this should be covered in footnotes to the financial statements; the essence of the explanation can also be covered in the certificate or can be handled by reference to the footnote to the financial statements. An example of the latter might be as follows (in the opinion paragraph): " - - - - in accordance with generally accepted accounting principles applied (except for the change in depreciation practice explained in Note __ to the financial statements) on a basis consistent with that of the preceding year."

Again, remember that you have a free hand in the manner of expressing qualifications or explanations; your efforts should be directed to making sure that the significance and application of your comments are clear.

The foregoing is obviously not intended as a full treatise on the subject for time limitations preclude that. It has not treated with cash basis statements, special purpose reports, reports involving accounting prescribed by regulatory authorities, etc. I think the observations do apply, however, to interim statements which many practitioners are called upon to render. I hope the thoughts suggested will be helpful to you.